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Manufacturing industry developments - 2003/04; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Manufacturing Industry Developments — 2003/04

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert is intended to provide auditors of manufacturing companies with an overview of recent economic, technical, and professional developments that may affect the audits they perform. The AICPA staff has prepared this document.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

This Audit Risk Alert is intended to help you plan and perform audits of your manufacturing clients. The knowledge delivered by this Alert can assist you in achieving a more comprehensive understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the manufacturing industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk).

Industry and Economic Developments

For a complete overview of the current economic environment in the United States, see the AICPA general *Audit Risk Alert—2003/04.*

General Industry Trends and Conditions

Manufacturing traditionally has provided the foundation on which the strength of the U.S. economy is built, and continues to be its most reliable prospect for future growth. The industry's share of the economy has been constant over the past half-century, consistently comprising between 16.1 percent and 17.3 percent of the U.S. Gross Domestic Product (GDP) over that period. And between 1992 and 2000, the manufacturing sector contributed 22 percent of overall GDP growth—more than any other individual sector.

However, the news has not been all good. While manufacturers experienced rapid growth during the 1992–2000 economic expansion, the industry also contracted faster than the rest of the economy during the past two recessions. The 2000–2001 manufacturing recession was the second longest in the past 50 years, and the 2002–2003 manufacturing recovery has been the slowest on record.

The most recent recession hit the manufacturing industry particularly hard, resulting in the loss of millions of jobs, and the failure of many smaller companies. After peaking at 17.3 million jobs in July 2000, manufacturing employment has fallen by 2.7 million over 36 consecutive months. And during the 18 months between June 2000 and December 2001, manufacturing production declined 7.4 percent. Although no longer declining, manufacturing production increased only 0.6 percent from November 2001 to June 2003.

The recent economic difficulties and a variety of long-term factors have created significant challenges for the manufacturing industry that have affected every aspect of their business. Global competition in the manufacturing industry is more intense than ever. The cost of manufacturing in the United States has increased at alarming rates, due in large part to increased costs for health care, litigation, and regulatory compliance. The near term, however, holds some promise. In the second half of 2003, the U.S. economy grew at its strongest pace in almost four years. Robust consumer spending and growing business spending is boosting economic growth; and manufacturers' orders for durable goods also are rising.

Global Competition

The U.S. trade deficit continued to widen as purchases of foreign goods and services climbed to their second-highest level in July 2003. No other single issue has negatively affected the manufacturing industry as has the dollar's overvaluation since 1997. However, the dollar has been weakening significantly during the second half of 2003 which helps exports of U.S. goods and U.S. manufacturers.

Global competition has been strong. Such intense competition can present a threat to the financial viability of domestic manufacturers. When such strong competition is accompanied by declining margins, some companies may feel the need to show positive financial results in order to stay in business and may try to manipulate numbers to achieve the desired outcome. See the "Consideration of Fraud" section of this Alert for a discussion of this and other fraud risk factors that need to be considered when performing an audit of a manufacturing company.

In order to be able to compete price-wise with foreign companies, some U.S. manufacturers are relocating their operations offshore in an effort to cut costs. See the "Movement of Domestic Operations to Overseas Locations" section of this Alert for a discussion of issues that may arise from a decision to move operations overseas.

The Need to Control Costs

One of the biggest challenges facing manufacturers today is the need to balance the lack of pricing power caused by increased international competition with rising business costs. Health care cost increases represent the single largest cost increase for manufacturers. But other costs, such as litigation, pension funding, salaries and related employee benefits, regulatory compliance, and energy continue to rise at alarming rates.

Electronic Commerce

The Internet is now an integral part of the U.S. economy. Many manufacturers are taking advantage of the speed and relatively low cost of e-business to transform their manufacturing, procurement, and other operations. In many cases, the changes in the way a manufacturer does business—with suppliers, plants, warehouses, distribution centers, sales channels, business partners, and customers—has been drastic. And while many of the changes are positive, they also present significant challenges to manufacturing companies. Delays in broadband deployment may prevent manufacturers from reaching their full potential. The Internet has further complicated security issues related to computer systems, making systems vulnerable to attacks by hackers. The auditor should be aware of the effect that e-commerce has on a manufacturing entity's internal control and other aspects of its business as he or she plans and performs the audit. See the "Auditing in an Electronic Commerce Environment" section of this Alert for a detailed discussion of this topic.

Regulatory and Legislative Issues

The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act dramatically affects the accounting profession and impacts not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly traded company, or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced into the business world. Most of the provisions of this legislation are specific to auditors of public companies.

Read the AICPA general *Audit Risk Alert 2003/04* for a description of recent and forthcoming rules and regulations implementing the Act.

Audit and Accounting Issues Arising From Current Risks

The intense competition existing today in the manufacturing sector presents unique challenges to auditors of manufacturing entities. In addition to the need to understand the industry and the nature of the client's business, the auditor must understand the pressures facing those clients that such challenges create. As such, the most experienced partners and managers must become involved early and often in the audit process. Each engagement should be properly planned, and the entire audit team should approach each engagement with the appropriate level of professional skepticism.

Consideration of Fraud

The financial pressures imposed by the increasing costs of manufacturing and global competition may encourage manufacturing clients to engage in fraudulent practices to hide the true extent of their financial difficulties. Such pressures, and the increased scrutiny focused on auditors as a result of much negative press and the passage of the Sarbanes-Oxley Act of 2002, should heighten the auditors' awareness of the possibility of fraud in their financial statement audits.

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides requirements and guidance for auditors to follow when considering fraud in a financial statement audit.

Among other things, SAS No. 99 requires the auditor to consider whether one or more fraud risks exist. Auditors of manufacturers should be aware of the following incentives or pressures, which may be present in the current economic environment.

Financial Stability or Profitability is Threatened by Economic, Industry, or Entity Operating Condition

A High Degree of Competition Accompanied by Declining Margins. Competition from foreign markets is particularly acute, especially from China. Where in the past the competition from China was limited mainly to low-cost exports, its recent expansion into more expensive, value-added products is placing tremendous financial pressure on U.S. companies. Being a communist dictatorship, China is able to control its economy to some degree and keep its manufacturing costs artificially low. Conversely, manufacturing costs in the U.S. have been increasing. U.S. manufacturers also must contend with foreign trade barriers, unfair trade practices, currency manipulation, and violations of intellectual property rights in the global marketplace. The increased competition has led to a failure of a number of manufacturers, while many are cutting back or eliminating production in the United States and relocating offshore (See the "Movement of Domestic Operations to Overseas Locations" section of this Alert).

High Vulnerability to Rapid Changes. The manufacturing industry is particularly sensitive to rapid changes in technology and product obsolescence. Short product life cycles are common in the manufacturing industry, especially in the high-tech sector. New and innovative manufacturing methods may render entire manufacturing operations obsolete and incapable of competing with those faster, more economical methods. As such, management may feel pressure to conceal the fact that some of its inventories are obsolete or its manufacturing facilities are impaired.

Excessive Pressure Exists for Management to Meet the Requirements or Expectations of Third Parties

Need to Obtain or Maintain Financing. With the economy growing strongly and economists predicting sustained growth in the future, manufacturers may seek new financing in either the credit or equity markets to help expand their operations. For entities seeking to raise capital, high earnings or sales figures are among the most convincing data the entity could present to potential lenders and investors. As such, an auditor may decide that additional audit procedures directed to the audit of revenues may be needed to address a possible risk of overstated revenue and earnings. Auditors may need to focus on management's estimates of future product returns that could have a significant effect on the entity's earnings or sales figures. Significant revenue recognized toward the close of the latest audited period merits special consideration. Auditors should review the possibility of returns on shipments, the inability of buyers to pay, and contingencies that may prevent revenue recognition.

Chapter 1 of the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk), provides detailed guidance for auditing revenue assertions, including consideration of internal control over revenue recognition, analytical procedures, cutoff tests, vouching, and other substantive tests of details and evaluating accounting estimates relevant to revenue recognition.

Vulnerabilities to Misappropriation of Assets

In addition to pressures and incentives that may cause management to engage in fraudulent financial reporting, the nature of the manufacturing industry provides a company's rank and file employees as well as outsiders with opportunities to commit fraud. Manufacturers that produce and carry inventory of items that are small in size, of high value, or in high demand are at risk of having these items stolen. Inadequate internal control over assets further increases manufacturers' susceptibility of misappropriation of those assets. Some vulnerabilities to misappropriation of assets in the manufacturing sector include:

- Inventory fraud such as theft or diversion
- Accounts payable and payroll fraud, such as phony suppliers or ghost employees
- Front-end and lapping frauds such as cash theft, cash skimming or accounts receivable lapping
- Secret commissions, kickbacks, and the like
- Outsider frauds such as inflated supplier invoices or product substitutions, con schemes, and the like
- Commercial crime by the organization, including environmental crime and violating occupational health and safety (OSHA) laws

Additional Procedures in Response to Fraud Risk

The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. However, because management may have the ability to override controls that otherwise appear to be operating effectively, it is unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls. In a manufacturing audit engagement, the auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. Some additional procedures the auditor may wish to consider include:

- Observing inventory on unexpected dates or at unexpected locations.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- More rigorously examining the contents of boxed items, the manner in which goods are stacked (e.g., hollow squares) or labeled, and the quality (i.e., purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard. Furthermore, additional testing of count sheets, tags, or other records, or the retention of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.
- Making oral inquiries of major customers and suppliers in addition to sending written confirmations, or sending confirmation requests to a specific party within an organization.
- Performing substantive analytical procedures using disaggregated data, for example, comparing gross profit or operating margins by location, line of business, or month to auditor developed expectations.

Practice Aid Available

The AICPA has developed a Practice Aid, *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613), that provides in-depth guidance on implementing SAS No. 99, and also discusses relevant accounting issues. Auditors of manufacturing companies may find *The CPA's Handbook of Fraud and Commercial Crime Prevention*, published by and available through the AICPA, especially helpful because it provides a list of fraud risk factors and key preventative controls for that sector.

Litigation, Claims, and Assessments

Nowadays, manufacturers across various industry sectors have to spend more and more money defending themselves in courts and paying various fines and penalties related to legal claims. Some of the matters that could lead to litigation, claims, and assessments were discussed earlier in this Alert. As an auditor of a manufacturing company involved in legal proceedings, you need to evaluate management's consideration of the financial accounting and reporting implications of those proceedings pursuant to FASB Statement No. 5, *Accounting for Contingencies*. FASB Statement No. 5 addresses the accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments.

Auditors need to be aware of their responsibilities under SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting for such matters when performing an audit in accordance with GAAS. The SAS provides, in part, that auditors should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments
- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

Because the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel; and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5. In addition, the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.

An auditor ordinarily does not possess legal skills, and therefore cannot make legal judgments concerning information coming to his or her attention. Accordingly, the auditor should request that the client's management send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Such procedures might include reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents; obtaining information concerning guarantees from bank confirmation forms; and inspecting other documents for possible guarantees by the client.

Collectibility of Accounts Receivable

A number of manufacturers are seeing a significant increase in the time it takes to collect from their customers. Some manufacturers may attempt to improve their year-end financial results by delaying the write-off of uncollectible receivables. Alternatively, companies may increase the amount of credit they are willing to extend to customers—even to those unable to pay amounts already owed—in an attempt to increase sales for the year.

As such, auditors may need to more closely evaluate the collectibility of accounts receivable. The client's estimate of the level of accounts receivable that may not be collectible as a result of bad debts is reflected in the allowance for doubtful accounts, which is one of the offsets used to bring accounts receivable to their net realizable value. (Other allowances include those for returns and rebates.) An audit of the allowance for doubtful accounts is an audit of an accounting estimate. When auditing estimates, auditors should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements. The guidelines set forth by SAS No. 57 include the following:

- Identifying the circumstances that require accounting estimates
- Considering internal control relating to developing accounting estimates
- Evaluating the reasonableness of management's estimate

As part of evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate for the allowance for doubtful accounts and, based on that understanding, use one or a combination of the following approaches listed in SAS No. 57.

1. Review and test the process used by management to develop the estimate.
2. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
3. Review subsequent events or transactions occurring prior to completion of fieldwork.

A review of the aging of the accounts receivable is often performed. This may include testing the reliability of the aging report, reviewing past due accounts on the report, including the number and amount of such accounts, reviewing past due balances, the client's prior history in collecting past due balances, customer correspondence files and credit reports, and so forth. This may be done with the assistance of the client in obtaining an understanding of how the allowance was developed and determining whether it is reasonable. Testing the reasonableness of the company's estimate of the collectibility of receivables may also be performed by using the following procedures:

1. Obtain publicly available information on major customers to determine their ability to honor outstanding obligations to the company.
2. Investigate unusual credit limits or nonstandard payment terms granted to customers.
3. Test subsequent collections of receivables.

Using Analytical Procedures, Ratios, and Post-Balance-Sheet Procedures

Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. According to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.02), analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Often, a large number of customer accounts makes it difficult to determine the adequacy of the allowance only by reference to individual accounts, making analytical procedures helpful to the audit process.

The following are examples of ratios that auditors might use to evaluate collectibility of accounts receivable:

- *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average net accounts receivable.
- *Bad debts to net credit sales* indicates whether write-offs are adequate. It is computed as bad debt expense divided by net credit sales.
- *Doubtful accounts allowance to accounts receivable* indicates whether the allowance account is adequate. It is computed as allowance for doubtful accounts divided by accounts receivable.

The auditor may also review revenue and receivables transactions and fluctuations after the balance-sheet date for items such as sales and write-offs. This may provide additional information about the collectibility of the accounts receivable and the reasonableness of the allowance account on the balance-sheet date.

Reliance on Maintaining, Extending, or Renewing Debt

Auditors should be alert to general economic and other conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about a manufacturing entity's ability to continue as a going concern. Given the very competitive environment that encompasses the manufacturing sector, auditors may need to pay particular attention to the client's short-term cash requirements and cash-generating ability.

Many companies are dependent on their current operating lines of credit or other borrowings to stay in business. As a condition of maintaining the credit, the company typically must comply with certain requirements stipulated by the lender. Often those covenants require the company to attain certain minimum financial goals, which may be difficult in this highly competitive environment. Failure to comply with one or more of those debt covenants puts the client in default on the loan, which may cause the loan to become due in full immediately. Auditors need to determine whether their clients are in compliance with all debt covenants. If the client is not in compliance with debt covenants, the auditor needs to find out whether the client has obtained a formal waiver from the lender regarding the noncompliance. If the client is unable to obtain such a waiver, the auditor should consider the likelihood that the loan will be called, and its effect on the company's ability to continue as going concern.

Clients that are overly reliant on external sources of financing also may find it difficult to extend or renew their loans when they become due. Such a situation could have significant audit ramifications, especially when the client is renegotiating the loan as the audit is being performed. Banks and other lenders frequently require that the company obtain an unqualified opinion on its audited financial statements prior to extending or renewing the credit. In such cases, the auditor should evaluate the company's ability to continue as a going concern assuming the credit is not granted, unless a formal commitment to extend the credit is provided by the lender.

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341.02 and .03*b*), as amended, addresses the auditor's responsibilities related to a going-concern issue. If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, he or she should give consideration to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, refer to the specific guidance set forth under SAS No. 59. SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), sets forth documentation requirements for auditors when a going concern issue exists.

Inventory

A growing trend in the manufacturing industry is the implementation of "lean principles" to reduce costs in response to the intense competition within the sector. Such principles encourage manufacturers to eliminate waste in their manufacturing process. Work in process has been identified as the most common form of waste in a factory—while product is waiting for the next value added operation, no value is being added to that product. As processes are updated and streamlined, companies must revise the way they assign costs at various stages. Inventory valuation ratios, such as gross profit ratios and inventory balances to anticipated sales volume, may not be useful in evaluating the reasonableness of inventory valuation if the changes are significant. The most significant changes are likely to occur in labor and overhead allocations. Auditors should become familiar with the new processes, and ensure the client has used reasonable assumptions and accurate data in determining labor and overhead allocations. In addition, the auditor may wish to consider changes in standards used by the industry, and pricing trends for the type of products sold by the client in determining the reasonableness of inventory valuations.

Movement of Domestic Operations to Overseas Locations

The cost of manufacturing in the United States continues to rise, due to increased costs of health care, litigation, and regulatory compliance. And while the overall price level for goods and services in the U.S. has risen 18 percent since 1994, the price level for manufactured goods has declined six percent over that same period. Faced with those increasing costs and inability to raise prices to offset those increases, many manufacturers believe they have no choice but to move their plants to overseas locations if they are to remain competitive. Auditors should be aware of the many issues that may arise from a decision to move operations overseas and should consider whether management has appropriately accounted for plant closings, personnel reductions, disposals of assets, and other related costs.

Impairment or Disposal of Assets

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of long-lived assets depends on whether the asset is to be held and used or held for disposal. Long-lived assets held and used should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred. Long-lived assets to be disposed of by sale (assets for which management has committed to a plan of disposal) generally should be reported at the lower of the carrying amount or fair value, less costs to sell.

The movement of a plant to an overseas location likely would be deemed an unusual or infrequent event. Unusual or infrequent (but not both) transactions or events are to be presented in the statement of income as separate elements of income from continuing operations, as required by APB Opinion No. 30. The presentation should not imply that the amounts are extraordinary items because they do not meet the criteria of being both infrequent and unusual. Clients may present plant closings on the face of the statement of income as a component of continuing operations, such as "provision for plant closing." Disclosures stating the effect and nature of the transaction or event can be made in the notes to the financial statements using captions, such as unusual items or nonrecurring items, as well as on the face of the statement of income, as stated above.

Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are to be considered as held and used until they are disposed of. If the asset is to be abandoned, the depreciable life is revised in accordance with APB Opinion No. 20, *Accounting Changes*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spin-off, an impairment loss is to be recognized at the date of exchange or distribution, if the carrying amount of the asset exceeds its fair value at that date.

Accounting for Exit Activities and Personnel Reductions

The movement of plants to overseas locations likely will result in significant reductions in personnel. In such cases, auditors should ensure they have properly accounted for employee-related termination charges, such as severance packages, voluntary separation charges, fees for outplacement services offered to their departing employees, and bonuses and educational allowances offered to assist employees in finding new jobs. Accounting literature that may need to be considered when employee layoffs occur includes:

- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies FASB Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." FASB Statement No. 146 requires that a liability for a cost associated with an exit or a disposal activity be recognized when the liability is incurred. The Statement also establishes that fair value is the objective for initial measurement of the liability.

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. This Statement establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailments, and paragraphs 15 through 17 for guidance on termination benefits.

- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* This Statement requires recording as a loss the effect of curtailments, for example, termination of employees' services earlier than expected. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailments. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, an amendment of FASB Statements No. 5 and No. 43. This Statement requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5, when four conditions are met. Inactive employees include those who have been laid off, regardless of whether they are expected to return to work. Postemployement benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage. FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. Financial statement disclosure should be made if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*. This Statement addresses disclosures only (that is, not measurement or recognition) and standardizes the disclosure requirements for pensions and other postretirement benefits. Among other disclosures, the Statement requires the disclosure of the amount of any gain or loss recognized due to a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.

Auditing in an Electronic Commerce Environment

Until recently, the business-to-consumer (B2C) sector of e-commerce (typically a retailer selling directly to the consumer) has shown the fastest growth. Lately, however, business-to-business (B2B) has shown the most growth potential, and the B2C growth rate now appears to be decelerating. The B2B model is typically characterized by a business selling up, down, or across the supply chain, involving business partners or business consortia. Therefore, B2B is the model most commonly employed by manufacturers. B2B transactions are more complex than B2C and have higher security needs. And, in general, B2B involves processing large transaction volumes and potentially large dollar amounts.

E-commerce has a number of significant audit and accounting implications, including the following:

- In addition to performing the audit, some CPA firms may provide nonattest services to a manufacturer involved in Internet transactions that will require consideration of independence issues. For example, designing, implementing, or integrating information systems for your audit client may impair independence. In such circumstances, the auditor should consider Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101). Auditors of publicly held entities should also consider independence rules recently issued by the Securities and Exchange Commission (SEC) (see Release No. 33-8183 at www.sec.gov).

- The technological skills required to fully understand the operations of an e-business and the manner in which business is transacted may be highly specialized. Having a sound understanding of these matters may therefore present a formidable challenge to the uninitiated. This is further complicated by the rapid change in technology, which may mean that you're chasing a moving target. While auditors are likely to have the requisite skill set to address many of the issues that arise in an e-business environment, some additional training may be required. In some cases the use of a technology specialist may be advisable. If the auditor decides to use the specialist, he or she should consider SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

- E-commerce will result in the increased use by manufacturers of electronic data to transact business, and to record, update, and maintain records. As a result, auditors of manufacturing companies increasingly will be confronted with evaluating evidential matter that may exist only in electronic format. SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically. One of the issues addressed by SAS No. 80 is the timing of the audit. Electronic evidence exists only for a limited amount of time and it may not be retrievable later if files are changed and backup files do not exist. Consequently, waiting until after fiscal year-end to begin auditing procedures may be too late to obtain competent sufficient evidence. The AICPA Auditing Practice Release *The Information Technology Age: Evidential Matter in the Electronic Environment* (product no. 021068kk) is designed to provide nonauthoritative guidance to auditors in applying SAS No. 80.

- The auditor also may be more likely to see prepackaged or customized computer systems used by manufacturing clients. In such circumstances, the auditor should evaluate management's consideration of Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

- The cost of developing a Web site may represent a large cost for manufacturers conducting a significant portion of their business over the Internet. EITF Issue No. 00-2, *Accounting for Web Site Development Costs*, provides guidance on this topic. The auditor may need to determine that management accounted for the costs of developing a Web site in accordance with the above-mentioned guidance.

- The use of e-commerce may result in a greater number of risks and uncertainties for the manufacturing entity. Auditors should consider whether management has evaluated all such risks and uncertainties appropriately and made any necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from e-commerce, pursuant to FASB Statement No. 5, *Accounting for Contingencies*.

- Changes in the way the client does business (such as a first-time venture into e-commerce) of course need to be considered by the auditor when planning the engagement, as discussed in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). As noted in SAS No. 22, in planning the audit, the auditor should consider, among other things, matters relating to the entity's business and the industry in which it operates, planned assessed level of control risk, and the methods used by the entity to process significant accounting information, including the use of service organizations such as outside service centers.

- E-commerce may result in rapid changes in the way transactions are processed, possibly without adequate consideration of the effect on internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

Recent Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the writing of last year's Alert. The PCAOB sets standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about PCAOB activities and any standards issued by the

PCAOB. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to AICPA Online at www.aicpa.org/members/div/auditstd/technic.htm and to the PCAOB Web site. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards Team and available at www.aicpa.org.

SAS No. 101	*Auditing Fair Value Measurements and Disclosures*
Audit Interpretation of SAS No. 58, *Reports on Audited Financial Statements*	Interpretation No. 16, "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508). Published in the June 2003 *Journal of Accountancy*.
Audit Interpretation of SAS No. 31, *Evidential Matter*	Amendment of Interpretation No. 2, "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326). Published in the June 2003 *Journal of Accountancy.*
Audit Guide	*Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (with conforming changes as of May 1, 2003)
Attestation Interpretation of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (Not applicable to attest engagements on public companies)	Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents" (AICPA, *Professional Standards*, vol. 1, AT sec. 9101).
SOP No. 03-2 (Not applicable to attest engagements on public companies)	*Attest Engagements on Greenhouse Gas Emissions Information*
Practice Alert No. 03-1 (Non-authoritative)	*Audit Confirmations*

Practice Alert No. 03-2 (Non-authoritative)	*Journal Entries and Other Adjustments*
Toolkit (Non-authoritative)	*Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141,* Business Combinations, *and Tests of Impairment Under FASB Statements No. 142,* Goodwill and Other Intangible Assets, *and No. 144,* Accounting for the Impairment or Disposal of Long-Lived Assets
PCAOB Rule 3100T (Applicable to public company audits only)	This rule generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices.
PCAOB Rule 3200T (Applicable to public company audits only)	This rule requires that in connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with GAAS, as described in SAS No. 95, as in existence on April 16, 2003.
PCAOB Rule 3300T (Applicable to public company audits only)	This rule requires that in connection with an engagement *(a)* described in the Auditing Standards Board's (ASB's) SSAE No. 10 and *(b)* related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the SSAEs, and related interpretations and SOPs, as in existence on April 16, 2003.
PCAOB Rule 3400T (Applicable to public company audits only)	A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in *(a)* the AICPA ASB's Statements on Quality Control Standards, as in existence on April 16, 2003; and *(b)* the AICPA SEC Practice Section's Requirements of Membership *(d), (f)* (first sentence), *(l), (m), (n)(1)* and *(o),* as in existence on April 16, 2003.

To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

Accounting Pronouncements and Guidance Update

Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. All FASB pronouncements are now available free of charge on the FASB's Web site. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy.*

FASB Statement No. 148	*Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*
FASB Statement No. 149	*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150	*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46	*Consolidation of Variable Interest Entities*

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Auditors of public companies should keep abreast of standards and rules issued by the PCAOB. The AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) summarizes some of the more significant ongoing projects and exposure drafts outstanding. Presented below is brief information about certain ongoing projects and exposure drafts that are especially relevant to the manufacturing industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

Standard Setting Body	*Web site*
AICPA Auditing Standards Board (ASB). *Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.*	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publishes exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

(Note that this discussion of auditing standards does not apply to the audits of public companies.)

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB has issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. (Among other things, this will improve the auditor's assessment of inherent and control risks and eliminate the "default" to assess these risks at the maximum.)
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Proposed Statement of Position, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* and proposed FASB Statement, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—An Amendment of APB Opinions No. 20 and No. 28 and FASB Statements No. 51 and No. 67, and a Rescission of FASB Statement No. 73*

Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods. A final SOP is expected to be issued during the fourth quarter of 2003.

Resource Central

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2003* (product no. 009895)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk)

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005133kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE: Online Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides (more than 20!), Audit Risk Alerts (more than 15!) and *Accounting Trends and Techniques*. To subscribe to this essential online service for accounting professionals, go to cpa2biz.com.

AICPA reSOURCE CD-ROM

The AICPA is currently offering a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature.* This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards, Technical Practice Aids,* and Audit and Accounting Guides (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737186kk (text), 187086kk (VHS tape/manual) and 187186kk (DVD)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.

- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.

- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards, SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 186748kk (VHS Tape/Manual), and 736749kk (text)). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2BIZ

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, *Professional Standards,* and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

This Audit Risk Alert replaces *Manufacturing Industry Developments—2002/03.* The *Manufacturing Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to rdurak@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*	*Recorded Announcements*
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	*AcSec Telephone Line* (212) 596-6008
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	
Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

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